Agenda Date: 4/26/06
Agenda Item: 2G

STATE OF NEW JERSEY

Board of Public Utilities
Two Gateway Center
Newark, NJ 07102
www.bpu.state.nj.us

ENERGY

I/M/O PUBLIC SERVICE ELECTRIC AND GAS COMPANY - PRIVATE LETTER RULING REQUEST SEEKING A FINDING THAT THE CONTINUED FLOW-THROUGH TO RATEPAYERS OF UNAMORTIZED INVESTMENT TAX CREDITS ASSOCIATED WITH CERTAIN DIVESTED GENERATING ASSETS WOULD NOT VIOLATE THE IRS' NORMALIZATION RULES	)	ORDER DOCKET NO. EO06040313

(SERVICE LIST ATTACHED)

BY THE BOARD:

As part of its August 24, 1999 Final Decision and Order in I/M/O Public Service Electric & Gas Company's ("PSE&G" or "Company") Rate Unbundling, Stranded Costs and Restructuring Filings, Docket Nos. EO97070461 *et al* ("1999 Order"), the Board of Public Utilities ("Board" or "BPU"), adopted, with specific modifications and clarifications, elements of a non-unanimous Stipulation between PSE&G and a number of parties in that proceeding ("Stipulation"). As part of the 1999 Order, the Board approved the transfer of PSE&G's generating assets to an unregulated affiliate. At the time, PSE&G had a significant accumulated deferred investment tax credit ("ADITC") balance attributable to its generation assets. The Stipulation did not resolve the disposition of the ADITC balance upon the transfer of the generation assets. The BPU's 1999 Order specifically held this issue open and directed PSE&G to seek a private letter ruling ("PLR") from the Internal Revenue Service ("IRS") to determine whether or not the value of the Investment Tax Credits ("ITC") could legitimately be credited to customers without violating the tax normalization policies of that agency. 1999 Order, at 125. By Order dated July 22, 2002 in I/M/O Petition of Public Service Electric and Gas Company for Approval of Changes in its Tariff for Electric Service, Depreciation Rates, and for Other Relief, Docket Nos. ER02050303 *et al.*, at 5-6, the Board reiterated its directive to PSE&G to seek the letter ruling from the IRS.

In accordance with that directive, by letter dated October 15, 2002, PSE&G requested the IRS to rule that it "will not violate the requirements of the investment tax credit normalization rules set forth in former Code §46(f) if it credits to customers the ADITC associated with the generating assets which have been sold to PSEG Power LLC as a part of Taxpayer's restructuring." (October 15, 2002 letter at 4). No final PLR has been issued by the IRS on this request to date.

By notice published at 68 Fed. Reg. 10190 (March 4, 2003), encaptioned "Application of Normalization Accounting Rules to Balances of Excess Deferred Income Taxes and Accumulated Deferred Investment Tax Credits of Public Utilities Whose Generation Assets Cease To Be Public Utility Property," the IRS proposed regulations providing for the flow-through of Excess Deferred Income Taxes ("EDFIT") and ADITC, concluding that neither former section 46(f) nor section 203(e) of the Tax Reform Act suggest that EDFIT and ADITC reserves should not ultimately be flowed through to ratepayers and that such flow-through therefore could occur without violating normalization rules. The regulations were proposed to apply to property deregulated after March 4, 2003, and utilities could elect to apply the proposed rules to property that became deregulated generation property prior thereto. The Board filed comments in support of the proposed regulations.

On December 21, 2005, the Board initiated a generic proceeding (BPU Docket Nos. EX02060363, EX02060364, EX02060365, EX02060366) in order to formulate an appropriate regulatory treatment for ITC related to generation assets. Comments were solicited and received from the State's electric distribution companies, and the Division of the Ratepayer Advocate ("RPA").

Also on December 21, 2005, the IRS withdrew its March 4, 2003 proposed rulemaking and proposed new regulations by notice published at 70 Fed. Reg. 75762 (December 21, 2005), encaptioned "Application of Normalization Accounting Rules to Balances of Excess Deferred Income Taxes and Accumulated Deferred Investment Tax Credits of Public Utilities Whose Assets Cease to Be Public Utility Property," with corrections published at 70 Fed. Reg. 76433 (December 27, 2005). The IRS again concluded that such flow-through would not violate normalization requirements provided certain criteria are met and proposed to permit such flow-through, but limited, however, to plant that ceased to be public utility property after December 21, 2005, with certain exceptions for plant that ceased to be public utility property on or after March 5, 2003. The Board has commented on the proposed regulations and urged the IRS to make certain modifications thereto, including, among other things, elimination of the arbitrary time constraints for allowing the flow-through to ratepayers of unamortized investment tax credits and excess deferred income taxes associated with divested utility plant.

In March 2006, the IRS informed PSE&G that it was tentatively adverse to the 2002 PLR requested by PSE&G. On April 6, 2006, at the Company's request, and pursuant to IRS procedures, a Conference of Right was held by telephone with the IRS and PSE&G, along with representatives of the Board. The IRS indicated that comments could be submitted within 21 days through PSE&G.

Thereafter, by telephone conference call on April 20, 2006, confirmed by letter dated April 21, 2006, the Board's Staff provided notice to the affected utilities and the RPA that this matter would be considered by the Board at its April 26, 2006 agenda meeting, and that the Board's Staff anticipated that it may recommend to the Board that, in light of the subsequent events described above, it reconsider prior directives to PSE&G, as well as directives to Jersey Central Power and Light Company ("JCP&L") and Atlantic City Electric Company ("ACE"), to seek private letter rulings from the IRS that the flow-through to ratepayers of unamortized investment tax credits and excess deferred income taxes associated with divested generation plant would not violate IRS normalization rules. The notice further indicated that Staff may recommend that the Board revoke its aforementioned prior directives to seek PLRs and direct the utilities to withdraw their requests for PLRs from the IRS immediately, with the flow-through issue continuing to be considered by the IRS in the context of its rulemaking, subject to judicial

review. An opportunity for each utility and RPA to submit comments on whether these actions should be taken by the Board was provided. By the April 24, 2006 deadline, PSE&G, JCP&L, ACE and the RPA provided comments.

By letter dated April 24, 2006, from Wilentz, Goldman & Spitzer P.A., by John A. Hoffman, Esq. ("PSE&G letter"), PSE&G objects to the potential Board action on procedural and substantive grounds, and argues that "a withdrawal of the ruling request would accomplish nothing." PSE&G letter, at 1. It further asserts that once the ruling request was filed, "it became a matter between the Company and the IRS, and it would be inappropriate for the Board to intrude into that bilateral process." PSE&G letter, at 1-2.

As to its procedural objections, PSE&G argues that the Staff recommendation should have been made by motion in accordance with rules governing motions in contested cases, including N.J.A.C. 1:1-12.2. It further contends that pursuant to N.J.A.C. 14:1-8.4, the Board may only reopen a proceeding if it has "reason to believe that conditions of fact or law have so changed as to require, or that the public interest requires, the reopening" and that the fact that the IRS may issue a ruling with which the Staff does not agree does not constitute a changed condition of fact or law, as the possibility that the IRS might rule that the credits could not be flowed-through to ratepayers had been contemplated when the Board issued the directive to file for a PLR. PSE&G also argues that there is no justification to invoke N.J.A.C. 14:1-8.6 to reconsider the prior Order.

PSE&G also maintains that a withdrawal of the PLR request will not alter the underlying tax law or the agency's interpretation of that law, and if the Staff believes that withdrawal of the ruling request will produce a more benign forum for consideration of the issue, it is wrong. While agreeing that there is no appeal from an adverse private letter ruling, it also asserts that there is no avenue of appeal from the issuance of adverse final regulations and that the "due process" steps in the rulemaking are not materially more robust, if at all, than in connection with the PLR request. It contends that "Staff's implication that somehow a normalization rulemaking would be judicially reviewable in a sanitized or declaratory fashion is incorrect." PSE&G letter, at 4. It also asserts that withdrawal of the ruling would not diminish the company's chances of being assessed on audit should there be a normalization violation, and it notes that under applicable IRS procedures, if a PLR request is withdrawn, the IRS National Office still notifies the taxpayer's IRS auditors of its views as to its conclusions.

PSE&G further claims that if the pending rulemaking when finalized permits the flow-through of its generation-related ADITC balance to customers without violating normalization rules, the finalized regulations would supersede any previously issued PLR. Thus, it asserts that if the normalization rules are retroactively altered, the PLR would not, as a matter of tax law, preclude application of the altered law, and therefore, issuance of a PLR would not preclude application of any new regulations which would otherwise apply. PSE&G also notes that it is not the only taxpayer with this issue, and New Jersey is not the only state with taxpayers with this issue, and there likely will be other PLRs on this issue even if PSE&G's request is withdrawn, and while such rulings would not be legally binding on the Company, "the reasoning is likely to be transparently applicable." PSE&G letter, at 5.

PSE&G also points to the IRS procedures for normalization rulings, which provide for additional inputs from the regulatory authority and consumer advocate, but which, once the additional inputs are received, it maintains reverts to a bilateral process between the IRS and taxpayer, and provides the taxpayer with tax, not regulatory, advice. PSE&G states that it "deems it critical that it be apprised of the tax consequences of the regulatory treatment described in the

ruling request." PSE&G letter, at 5. PSE&G, therefore, concludes that the IRS PLR process should be continued to its conclusion so as to receive the IRS position sought by the Board in the 1999 Order.

By letter dated April 24, 2006 from the RPA by Diane Schulze, Assistant Deputy Ratepayer Advocate ("RPA letter"), the RPA requests that the Board order PSE&G, as well as JCP&L and ACE, to immediately withdraw their PLR requests addressing the ITC issue due to the proposed IRS regulation on the issue. The RPA maintains that with the delay in the IRS responding to the PLR requests, circumstances have changed to make the rulings no longer necessary. The RPA asserts that the "letter rulings are no longer necessary and may even be detrimental to obtaining clarification on the issue." RPA letter, at 7. The RPA asserts that the Board's directive to file for a PLR was made with the expectation of a timely IRS response, and when a response from the IRS was not forthcoming, and the Board was forced to make stranded cost determinations without IRS guidance. The RPA further argues that "issuance by the IRS of the proposed regulations effectively superseded any previous request for a private letter ruling" and in the interest of ensuring uniform treatment, the utilities should have withdrawn their requests with issuance of the March 2003 proposed regulations. RPA letter, at 8. The RPA contends that an adverse ruling at this late date will "severely limit" the Board's options in protecting ratepayers' interests, while if the PLR request is withdrawn, the Board would have the flexibility to await the IRS regulation and once the IRS' final position is public, to act accordingly. It also asserts that piecemeal determinations should be discouraged and the full IRS rulemaking should proceed before making a final determination on the ADITC reserves. Maintaining that the proper way to resolve the issues is through rulemaking, which includes both the opportunity for fair comment and standing to appeal, the RPA requests the Board to direct the utilities to immediately withdraw their requests for private letter rulings.

The Board has carefully considered the submissions of PSE&G and the RPA. As to PSE&G's procedural contentions, the Board finds that its Staff, which is acting in an advisory capacity to the Board with regard to the PLR request and the IRS rulemaking, was not required to first file a formal motion consistent with the time constraints of a motion in a contested case. The PLR request is not a contested case before the Board. Nonetheless, Staff sent the letter to the affected parties in order to solicit their respective positions on this issue, so that they could be conveyed to and considered by the Board when it considers this issue. Moreover, because comments to the IRS are due by April 27, there is a need to consider this matter expeditiously. PSE&G has had an opportunity to provide its comments to the Board, and has, in fact, submitted detailed comments, such that any informality or irregularity has not impaired PSE&G's rights or interests.

The IRS has clearly recognized that the flow-through issues are appropriate for rulemaking by publishing two notices of proposed regulations, in 2003 and 2005. While the IRS has indicated that, before its 2003 proposed rulemaking, it had issued PLRs holding that flow-through of the EDFIT and ADITC reserves associated with an asset is not permitted after the asset's deregulation, based on the principle that flow-through is permitted only over the asset's regulatory life and when that life is terminated by deregulation no further flow-through is permitted, after further consideration the IRS and the Department of Treasury have concluded that the relevant statutory provisions do not prohibit a utility from flowing through ADITC reserves after deregulation and EDFIT reserves with respect to deregulated utility property. 2005 Rulemaking, at 75763. As the IRS explained in its 2003 proposed rulemaking:

> After further consideration, the Service and Treasury have concluded that neither former section 46(f)(2) nor section 203(e) of the Tax Reform Act suggests that the EDFIT and ADITC reserves should not ultimately be flowed through to ratepayers. Instead, Congress provided a schedule for flowing through the reserves so that utilities would have the benefit of cost-free capital for a predictable period.
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> [2003 Rulemaking, at 10191 (emphasis supplied)].

The statutory provisions that the IRS cited in the 2003 Rulemaking contemplated that the utilities would flow these monies through to ratepayers in accordance with a schedule, but nothing in those provisions suggested that the utilities could turn "the benefit of cost-free capital for a predictable period" into a permanent benefit of cost-free capital without any obligation to pass that benefit along to the ratepayers.

Similarly, in its 2005 Rulemaking, the IRS explained its interpretation of the relevant statutory provisions:

> After further consideration, the IRS and Treasury have concluded that former section 46(f) does not, in all cases, prohibit flow-through of ADITC reserves after deregulation and that section 203(e) of the Tax Reform Act does not preclude flow-through of the EDFIT reserve with respect to deregulated property.
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> [2005 Rulemaking, at 75763 (emphasis supplied)].

As to the flow-through of ADITC reserves, the IRS further explained in its 2005 Rulemaking:

> If an asset qualifying for the investment tax credit is purchased by a utility, the allowance of the credit, without flow-through, lowers the utility's actual tax expense but does not result in higher tax expense for ratepayers than would have been the case if the asset had not been purchased. Thus, in the absence of flow-through, the investment tax credit is a subsidy from the Federal government for the purchase of the asset rather than a transfer from ratepayers to the utility. The underlying policy of former section 46(f) is to share this subsidy between ratepayers and utilities in proportion to their respective contributions to the purchase price. In general, former section 46(f) treats ratepayers as contributing to the purchase price when ratemaking depreciation expense with respect to the asset is included in the rates they pay, resulting in full flow-through over the asset's regulatory life. In the case of a deregulated asset, the contribution of ratepayers can be appropriately measured by the ratemaking depreciation expense they are charged with respect to the asset and any additional stranded cost that the utility is permitted to recover with respect to the asset after its deregulation.
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> [2005 Rulemaking, at 75763 (emphasis supplied)].

Accordingly, based on the IRS' interpretation of the relevant statutes and their underlying policy and intent, the proposed regulations would permit flow-through of the ADITC reserve with respect to public utility property to continue after its deregulation to the extent the reduction in cost of service does not exceed, as a percentage of the ADITC with respect to the property at

the time of deregulation, the percentage of the total stranded cost that the taxpayer is permitted to recover with respect to the property. In addition, the credit may not be flowed through more rapidly than the rate at which the taxpayer is permitted to recover the stranded cost with respect to the property.

Although the 2003 proposed regulations would have permitted utilities to elect to apply the proposed rules to property that was deregulated on or before March 4, 2003, the 2005 Rulemaking proposed other provisions pertaining to the regulations' effective date:

> Comments suggested that deregulation agreements between utilities and their regulators entered into before the March 4, 2003 proposed effective date were based on the only guidance then available (*i.e.* ,the private letter rulings issued by the IRS) and that the availability of a retroactive election could effectively change the terms of those agreements. Although private letter rulings are directed only to the taxpayers who requested them and may not be used or cited as precedent, the IRS and Treasury have concluded that the Secretary's authority under section 7805(b)(7) to provide for retroactive elections should not be exercised in a manner that impairs existing agreements between utilities and their regulators.
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> [2005 Rulemaking, at 75763 (emphasis supplied)].

As the Board explained in its comments on the proposed regulations, this proposed rationale for eliminating retroactivity simply does not apply to the situation in New Jersey. Although New Jersey's electric industry completed its deregulation prior to March, 2003, the Board specifically carved out the issue of proper treatment of ADITC in its restructuring orders, including the PSE&G restructuring order. Indeed, in PSE&G's request for a private letter ruling, PSE&G so recognized in stating that neither the Stipulation nor the Board's Final Decision and Order provided for the disposition of ADITC upon the impending sale of the assets.

Thus, the Board's 1999 Order did not depend at all on any Private Letter Rulings that preceded it. On the contrary, the Board's 1999 Order left this issue open and directed PSE&G to seek a letter ruling from the IRS to determine whether or not the value of the ITC can legitimately be credited to customers without violating the tax normalization policies of that Agency to the detriment of the Company and the customers. .Accordingly, flow-through could be allowed without making any change in the terms of the Board's 1999 Order and without making any change in the basis for that order contemplated by the parties at the time it was issued, and without impairing any existing agreements between utilities and their regulators. The reasoning underlying the 2005 Rulemaking's effective date therefore is inapplicable to PSE&G's request and should be modified, as the Board submitted in its rulemaking comments to the IRS.

Notwithstanding its own proposal of rules in March 2003 to interpret the relevant statutory provisions, and its own proposal of rules again in December 2005, and its having afforded opportunities for interested parties to provide comments on the proposals for the IRS' consideration, the IRS apparently now seeks to issue interpretations through a series of private letter rulings addressing PSE&G, two other New Jersey utilities, Jersey Central Power & Light Company, and Atlantic City Electric Company, and possibly a number of other utilities as well. While the IRS has indicated that the Board and the RPA may submit comments on this issue by April 27, 2006, through the taxpayer utility, the IRS has asserted further that no such third party would have standing to contest a private letter ruling through judicial review. The IRS should not take action of such broad scope and applicability, with such a large financial impact on

millions of ratepayers, through a piecemeal process that eliminates any real scrutiny on behalf of the many people affected by the action. The IRS should, as it is in the process of doing, resolve the outstanding questions by considering the comments of the Board and other interested parties and finalizing its proposed rulemaking, subject to such judicial review as may be appropriate. Were the IRS to issue a PLR without first completing its pending rulemaking, including that part of the rulemaking pertaining to the effective date for the IRS' statutory interpretations, it would vitiate the opportunity to be heard that was to be provided to the Board and other interested parties in the rulemaking, and would prematurely judge issues prior to their full and due consideration by the IRS pursuant to its own notice of rulemaking. Moreover, proceeding in such manner could result in disparate treatment depending on whether a public utility sought a PLR or is governed by the rulemaking. Such disparity would be particularly unfair in the context of a regulatory agency such as the Board, which attempted to obtain guidance from the IRS, even prior to the rulemaking. Additionally, as to PSE&G's contention that the finalized regulation would supersede any previously issued PLR, that is not certain at this juncture, and, in fact, the IRS' current proposal provides that as to public utility property deregulated on or before December 21, 2005, the IRS will follow holdings set forth in previously issued PLRs.

For the foregoing reasons, in recognition of the changed circumstances since its 1999 Order, and after careful consideration and balancing of the interests and concerns of PSE&G, which, in its request for a PLR, supported and argued for the flow-through of ADITC to ratepayers, and the interests of its ratepayers, who, prior to divestiture, funded PSE&G's assets through depreciation charges and who, post-divestiture, continue to fund nearly $3 billion in stranded costs related to these generating assets, the Board believes that the flow-through issues should be considered in the pending rulemaking and the IRS, therefore, should not issue a Private Letter Ruling to PSE&G to address these same issues prior to the final resolution of the pending rulemaking. The Board emphasizes that proceeding in this manner is consistent with Internal Revenue Procedures which provide that letter rulings are given when appropriate in the interest of sound tax administration, and that the IRS "will not issue a letter ruling if the request presents an issue that cannot be readily resolved before a regulation or any other published guidance is issued." Rev. Proc. 2006-6.09. While the Board concurs with PSE&G as to the need for the IRS' guidance as to the tax consequences of a flow-through of ADITC to ratepayers, given the IRS' own rulemakings proposing different provisions as to effective dates of the IRS' statutory interpretations, the request at issue cannot be readily resolved before the rulemaking concludes. IRS procedures also provide that a taxpayer may withdraw a request for a letter ruling at any time before the letter ruling is signed by the IRS, Rev. Proc. 2006-7.07, and the Board FINDS that in the within context, unless the IRS will grant a request to hold the PLR request in abeyance pending the rulemaking, PSE&G should withdraw its PLR request.

Accordingly, pursuant to N.J.S.A. 48:2-40, and in light of the subsequent events described above that have occurred since the issuance of the 1999 Order, the Board HEREBY MODIFIES its prior directive to PSE&G to seek a PLR, and DIRECTS PSE&G to deliver to the IRS, by 5:00 p.m. on April 27, 2006, a withdrawal of its request for a PLR. However, PSE&G may state in its withdrawal that if the IRS agrees not to issue a PLR until after there has been a final resolution of an IRS rulemaking that addresses the tax implications of flowing through the ITC to ratepayers, including any appeals from the rulemaking, then PSE&G's request for a PLR shall be deemed not to be withdrawn. PSE&G shall simultaneously file with the Board's Secretary a copy of its withdrawal of the PLR, stating the date and time on which the withdrawal was delivered to the IRS. The Board emphasizes that its determination whether the ITC is to be flowed through to ratepayers continues to remain open pending the resolution of the issue through IRS rulemaking, and that the Board is not directing flow-through of the ITC at this time.

Additionally, the Board further DIRECTS PSE&G to deliver to the IRS, by 5:00 p.m. on April 27, 2006, comments to be received from the BPU which will urge that the PLR request be held in abeyance, as well as comments by the RPA with respect to the proposed PLR.

The Board reserves the right to take such action as may be necessary to enforce this Order and authorizes the Attorney General's Office to take such action as may be so necessary.

DATED: April 26, 2006

BOARD OF PUBLIC UTILITIES
BY:

JEANNE M. FOX
PRESIDENT

FREDERICK F. BUTLER
COMMISSIONER

CONNIE O. HUGHES
COMMISSIONER

JOSEPH L. FIORDALISO
COMMISSIONER

CHRISTINE V. BATOR
COMMISSIONER

ATTEST:

KRISTI IZZO
SECRETARY

I HEREBY CERTIFY that the within document is a true copy of the original in the files of the Board of Public Utilities